BULLETIN

of

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

OCTOBER, 1930

110 WILLIAM STREET
NEW YORK, N. Y.

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

OFFICERS

ARTHUR H. CARTER .... *President*
WALTER A. STAUB .... *First Vice-President*
MARTIN KORTJOHN .... *Second Vice-President*
FRED L. MAIN .... *Secretary*
PRIOR SINCLAIR .... *Treasurer*

BOARD OF DIRECTORS

PAUL E. BACAS
SAMUEL J. BROAD
THOMAS F. CONROY
WALTER N. DEAN
EMANUEL ENGEL
MAX FINK
WINFIELD MCKEON
JOHN T. MADDEN
ALEXANDER F. MAKAY
MAURICE E. PELOUBET
JAMES L. RIDGWAY
MORRIS C. TROPER

AND THE OFFICERS
WHO ARE ALSO DIRECTORS

W. ALCORN BROWN .... *Assistant Secretary*
110 William Street, New York City

Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—From the Certificate of Incorporation.

FOREWORD

To the Members of The New York State Society of Certified Public Accountants:

IT HAS been felt for some time past that, with the ever-increasing activities of our Society, some means should be taken to bring the members into closer contact with the administration as well as to keep them in touch, through the Society, with developments in the professional field.

To this end a new standing committee—the Committee on Publications—was recently appointed by the President, and has undertaken the responsibility for the issuance of periodical bulletins and also other Society publications.

For the present it is anticipated that the BULLETIN will be issued quarterly; it will contain news of Society activities and will deal, in addition, with matters of special interest to accountants in the practice of their profession.

The Committee bespeaks, and will welcome, suggestions and comments from members directed towards the production of a bulletin that will be both useful and informative.

THE COMMITTEE ON PUBLICATIONS

SAMUEL J. BROAD
CHARLES B. COUCHMAN
MORRIS C. TROPER, *Chairman*

CONTENTS

BULLETIN

OF

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

[*The matter published in this* BULLETIN, *unless otherwise stated, will not be binding upon the Society; and it should be understood that any opinions expressed in articles published in the* BULLETIN *are the opinions of the authors of the articles, respectively, and are not promulgated by the Society.*]

Series A **OCTOBER, 1930** **No. 1**

A MESSAGE FROM THE PRESIDENT

THE purposes for which The New York State Society of Certified Public Accountants was originally organized have necessarily been extended recently to include the dissemination of information relating to accountancy to the general public and to others interested in that subject. It would seem that the Society, and every member thereof, should take advantage of the opportunities the recent past and present conditions in the general business situation offer to meet immediately the obligations we have assumed.

Abnormal prosperity and subnormal depression in business destroy ratios, prevent reasonable comparisons, and have a tendency to warp sound judgment. Conservative accounting policies, scientifically provided and consistently followed, will disclose a sound course for every business, and the certified public accountant who serves well will more than justify his fee if he assumes the position of an advisor to his client in determining such policies.

The general public, and particularly the increasing number of so-called investors, seem to have acquired much greater respect for accounting and for the certified public accountant during the last few years. Financial statements have been studied with much more understanding than ever before, and as the financial interests of the investing public spread greater dependence will be placed upon a correct interpretation and clear presentation of facts relating to investments. The time

is fast approaching when financial statements, verified by independent accountants, will be demanded by the investor.

In my opinion, we, individually as members, and the Society through its Board of Directors and Officers, should take advantage of every opportunity to continue the present interest on the part of the general public in accounting. The tendency in modern business is to give more and more information to the public, and it is incumbent upon the certified public accountant to protect business organizations and the public by setting forth financial facts in statements so clear that "he who runs may read" and accept them with firm confidence.

The members of our Society have a great responsibility to the profession due to their close contact with the major developments of business and their effect upon the practice of accountancy.

Never in the history of our profession has there been a greater demand for cooperative effort of practicing accountants in facing their problems. We are constantly confronted with matters of mutual interest and I hope that the members of our Society will give more thought than they have in the past to the importance of maintaining closer relations. The New York State Society provides a means by which such relations may be maintained to the advantage of every member. The success of our Society will be assured if every member does his part.

ARTHUR H. CARTER,
President.

CO-OPERATION WITH BANKERS

Interesting Views Expressed in the Report of the Committee of The Robert Morris Associates Presented at the Dallas Meeting

[*The report of the Committee of The Robert Morris Associates on Co-operation with Public Accountants, given below, was submitted at the meeting of that organization at Dallas, Texas, May* 12, 1930. *By courtesy of the Chairman of the Committee, Mr. H. E. Whitney, the report is reproduced here for the information and guidance of the members of The New York State Society of Certified Public Accountants. Reports of this Committee for several years preceding were printed in the Society's* NEWS BULLETIN *of January* 22, 1930.]

Dallas Report of the Committee of The Robert Morris Associates

SINCE the Pittsburgh meeting last October the activities of the committee have continued along the accepted lines with which most of you are familiar. Nothing startling has developed but we will cite a few circumstances that came to our attention confirming our preachments that financial statements, even though audited, should be fully and carefully analyzed.

Our members must bear in mind that the accountants do not underwrite our loans. When that time comes, we will lose our jobs. At the best, an unqualified certificate of a reputable accountant indicates merely that *in his opinion* the statement is correct. Now we should respect such an opinion but that doesn't mean we should not form one of our own and we can do that only by giving to the set up (by that we mean the figures, captions, certificate and comments) our critical and analytical attention.

As this report was being drafted, your chairman received from one of the members of the committee, a memorandum of four separate items not properly captioned in a financial statement that just came to his attention. This committeeman talked with one of the partners of the accounting firm who frankly admitted the rather loose presentation of the data and stated that at a meeting of his general organization which he had called for next week, he would make a special point of this incident so that there would be no recurrence.

Certificates

The reports of the committee for the past few years rarely omit a reference to the importance of a close reading of certificates or comments accompanying an audited statement. An instance came to our attention of a financial statement showing approximately $800,000 of receivables. Inquiry developed that possibly 50% of these, or in round numbers $400,000, were of more or less doubtful liquidating value and unquestionably a substantial reserve item should have been set up. However, the accountants may have covered themselves by the following phrase, which appears among the comments:

> "The management informed us that the reserve for doubtful accounts in the sum of $3000 is sufficient to cover possible losses in the liquidation of these accounts."

You will note that in this phrase the accountants throw back upon the management full responsibility for the deficiency of the reserve and yet this phrase appearing in the middle of six pages of comments might easily be overlooked.

Receivables

A financial statement showed an item of bills receivable totaling $328,000 of which $315,000 was due from a wholly owned subsidiary, and an item of accounts receivable $3,140,000 of which $1,300,000 was due from the same subsidiary. The detailed audit separated these accounts but in making up the statement for the use of the banks and the commercial paper broker the items were condensed. Incidentally the statement was not captioned as "condensed" which when done is sometimes used by an accountant as an excuse for not specifically segregating such items though this is not sanctioned by good accounting practice. The accountant frankly admitted that it was gross carelessness.

Investments

In November, 1928, our attention was called to the fact that a financial statement included among current assets an item "Stocks—$310,000." We suggested to the accountant that such an item should not be included as current unless it represented recognized marketable securities or the investment was of a temporary character, neither of which, we happened to know, applied in this particular case. The accountant claimed he had satisfied himself that notwithstanding the fact this investment was in stock of a cotton mill, it could be disposed of within 90 days at the price listed. After further correspondence and a personal discussion with one of the members

of our committee, he conceded our contention and we are glad to make record of the fact that in the August, 1929, statement it was properly listed among the deferred assets.

Contingent Liabilities

A consolidated financial statement showed no contingent liabilities. Upon obtaining the individual statements of the two companies that went to make up the consolidated statement, it was noted that one of these companies had a contingent liability for bills receivable rediscounted, of $10,800. When this was called to the attention of the accountant his explanation was that he considered it immaterial as bearing upon the consolidated financial statement in view of the fact that the excess of current assets over current liabilities was very many times the amount of the contingent liability. This is another case of which we have had so many in the past and of which we will continue to have many in the future, where the accountant reserves to himself the right to determine what is material and what is not. In this situation we are not inclined to agree with the accountant for while it is true a $10,000 contingent liability under the circumstances outlined is not a serious matter, the fact that it does exist indicates a practice of the company to rediscount receivables and it is quite possible that at other times during the year such a practice might result in a very substantial contingent liability. If the client objects to the showing of such a liability, he should discontinue the practice of discounting his receivables.

Laxity of Banks

We have had occasion from time to time to criticize certain accountants because in listing liability items, notably acceptances under letters of credit, they have neglected to state specifically that these were secured. It has been a matter of some embarrassment that in two specific instances the accountant has been able to submit documentary evidence showing that the banks in certifying to the accountant as to the obligations outstanding on statement date, have neglected to state that these obligations were secured, notwithstanding the fact that the accountant's blank particularly asks as to this point. In another instance a bank had a note for a substantial amount bearing the endorsement of the company regarding which the accountant asked for a report and the bank did not mention this fact.

This is a matter that the members who hear this report or who read it, should immediately take up with their auditing departments for the purpose of correcting this laxity.

General Comment

The committee continues to receive friendly cooperation on all matters which it has occasion to discuss with the accounting fraternity. Only recently a prominent accounting firm spoke with your chairman about their practice of including as current assets such items as prepaid interest and insurance. They were advised that we construed a current asset only as something that would in the usual course of business be converted into cash and thus be made available for the payment of current liabilities and cited the fact that the pamphlet, "Verification of Financial Statements," specifically provides that prepaid items of the type just mentioned should not be carried as current. The senior partner of this firm later wrote advising that they thoroughly agreed with this premise and in the future all their reports would be prepared accordingly.

There are many ways in which the banks may cooperate to a greater extent with the accountants and at this time we would call attention to two of them. When you receive a financial statement certified to by a firm of accountants different from the one whose name appeared on the previous figures, it is well to inquire into the circumstances, for it has developed on a number of occasions that the former firm has for one reason or another seen fit to decline to prepare or certify to the new figures. It is important that the banks should know this and equally important that we support the previous accountants in their attitude. It must be a bit discouraging to an accountant to refuse to prepare or certify to a statement and then find that the principal had gotten some other accountant to do the job and the banks were not enough interested to inquire into the change. As one of our members so aptly pointed out, speaking only from a selfish standpoint, we should be just as much interested in knowing why there was a change in accountants as in knowing why there was a change in bank accounts and we never fail to inquire into the latter.

Another way in which we could help would be to make a point of congratulating our customers whenever they submit to us an audited report which seems to be particularly complete and comprehensive. The chances are the accountant sold our customer the idea of such a report.

We know of a number of chapters that during the winter have had meetings with accountants and your chairman would like to refer particularly to the one held in New York. This meeting was conducted along lines somewhat different from

customary. There were no prepared speeches but in sending out the announcement of the meeting the members were advised that they should come to the meeting prepared to ask questions upon any accounting problems not clear to them and submit instances of what, in their opinion, represented violations of ethics in the preparation of any audited financial statements they may have had occasion to analyze. The president of the American Institute of Accountants and the president of The New York State Society of Certified Public Accountants were present in person and the discussions that resulted were most illuminating and instructive, and undoubtedly the members present profited to a much greater extent than would have been the case had they listened merely to prepared addresses. In a meeting of this character the members get out of it just as much as they put in it and some of the other chapters might find it interesting to try something along these lines.

Respectfully submitted,

John Clayton
J. N. Eaton
P. F. Gray
G. A. Van Smith
H. S. Wass
H. E. Whitney, *Chairman.*

FRAUDS AND DEFALCATIONS*

By George L. Naught, Vice-President & General Counsel, American Surety Company of New York

THE subject "Frauds and Defalcations" assigned to me is broad enough. As I approach this subject with a thirty minute paper, I feel somewhat like the father who was asked one evening by his little son to be told all about the world before bedtime.

The subject invites debate concerning our penal laws, concerning instruction in the home, the schools and the churches and concerning heredity—the transmission of physical and psychical qualities from parent to offspring. But at this time I assume that you and I must think less of the causes and more of the methods and effects of frauds and defalcations. When we do look for the causes of frauds and defalcations we find them primarily attributable to warped consciences stirred by false courage. Sometimes they are provoked by necessity. There are those who will urge that the World War may be blamed for most of the confusion and violation of law that we have since experienced; others will urge that all our business troubles are caused by a get-rich-quick spirit that is alleged to be typically American; and still others are certain that our prohibition laws alone have caused revolt by upsetting the morale of half our people; and many others have their various arguments as to what are the most disturbing and undermining influences. All of us will concede that properly enforced laws prove a great deterrent to frauds and defalcations but we know that a proper enforcement of our present laws could not prevent entirely the commission of such crimes. If my judgment were asked as to the present trend of human conduct, I would at least hold that the Golden Rule days promised in our boyhood as a future inheritance are somehow becoming so merged as to lose their identity, or there has been a postponement of their delivery. We will meet those who think we might legislate ourselves into a utopian era. Millions of men contend that we cannot. We know that the theories, estimates and principles of our people are so much at variance as to be unreconcilable. What one would condemn most another deems permissive. One man would falsify figures but he would draw the line at lying in conversation. An illustration of this

* An address delivered before the Eighth Annual Fall Conference of The New York State Society of Certified Public Accountants, New York City, October 20, 1930.

was given some time ago when a well known member of your Society was checking the accounts of a certain man. During the examination, the accountant found nothing wrong with the figures and records subject to consideration, nevertheless he developed a suspicion in regard to certain transactions recorded and was therefore doubtful about his findings. After reflecting briefly, the accountant turned to the man whose work he was checking and inquired in a rather direct manner, "Is that all, Mr. Blank?" After an interval the reply came, "No sir, I cannot tell a lie." Whereupon the defaulter proceeded to explain. There the accountant found a man whose code of morals did not prevent him from embezzling many thousands of dollars but who could not lie about it. He died in prison.

I am sure there can be no sufficient summarizing of all the excellent work you are doing to expose and discourage fraudulent practice and defalcations. The American Surety Company with its forty-six years of experience is also assuming its share of the burden of such responsibility. We find the most shocking those frauds and defalcations which have no excuse of necessity for their commission. They are caused often by officials whose reputations have been beyond challenge—officials whose incomes and possessions have been more than adequate to enable them to live and maintain their families in comfort and in excellent standing, if not in luxury. Illustrative of this type of defaulter I will tell you of a development that was interesting to me. In a city west of us, a president of a national bank, feeling the burden of continuing the management of the bank, was anxious to secure the services of the cashier of another bank in the same city. This desire led finally to a merger with the national bank with the result that the admired and capable cashier was elected cashier and later vice-president of the national bank. The president of the national bank and his family were socially very intimate with the new cashier and his family. The president of this bank was very wealthy and—the new cashier was reputed to be worth a third of a million. The bank carried on with its new cashier's assistance for several years, but for some reason, probably because of dissension among the directors, a new vice president was elected to be executive in charge of this national bank. The new vice president, when checking outstanding loans of the bank, discovered a note that a further examination disclosed had been paid off long before; and it was claimed that other paper and entries by the cashier, and his misappropriation of customers' securities disclosed his total shortage in excess of $250,000. Naturally we wonder why

such a cashier, respected in his community, living in a beautiful home with more than enough money for the reasonable requirements of himself and family, should be a defaulter.

The discovery of this default developed a very complicated suretyship situation. The bank had made many changes in its suretyship coverages and the cashier was chiefly responsible for that. In making claim against the various sureties the bank experienced considerable difficulty and incurred much expense. Although the items making up the total shortage all appeared to be in current loans and accounts, that did not necessarily mean that the bank sustained its loss when default or fraudulent loan entries were made. There was great difficulty experienced in properly allocating the various items of loss so that they could be properly and lawfully stated against the various bonds of suretyship carried by the bank for different terms during the long period of its cashier's performance.

For several years suretyship in the form of bankers' blanket bonds has been very popular with the banks. Bonds to the national bank I have referred to carried this form. The bankers' blanket bond form usually provides that the bank holding it shall have a period of one year after the termination of the bond within which losses, created while the bond is in force, may be discovered. It is also the practice of a surety company superseding a prior surety, to issue a superseding suretyship rider which, by its terms, provides in effect that the bank holding it shall be entitled to claim under the blanket bond of the superseded surety for losses which may have been created and which would have been claimable under the prior bond of suretyship but which had not been discovered within the year's limitation from the cancellation date of the prior bond. You can therefore appreciate the necessity for the burden being placed upon the insured bank to definitely establish the exact date when loss actually occurred. If a loss which was created during the period of the prior bond was discovered after the cancellation of the bond but before the expiration of the one year limitation, the claim therefor should be properly asserted against the prior surety and not against the superseding surety. Along with this blanket bond coverage there is sometimes issued what is termed excess bond coverage—usually a more restricted coverage and which indemnifies against loss in excess of primary bond coverage. The excess blanket bond is issued for a reduced rate of premium and it clearly and definitely and with limitation provides as to loss for which it may answer in excess of loss created under the primary bond. A proper allocation of loss on the said national bank claim in the sum of $75,000 meant a loss to the surety of $10,000 only.

Upon application to it for a bond covering an employee, the surety company always tries to ascertain information concerning the character of the risk it is asked to assume but it often finds that the excellent previous record of the employee is not sufficient warranty as to his future conduct. I recall our having bonded for a period of years an employee with an excellent record—another bank cashier. When the bank closed its doors as a result of this cashier's shortage, the examiners found that he had stolen half of the assets of the bank amounting to about two million dollars. The figures showed the following:

Loss due to cashier's embezzlement	$983,247.83
Amount of the American Surety Company's bond paid and deducted	50,000.00
Excess loss to the bank............	$933,247.83

This cashier had been in the bank's employ for twenty-two years before he began his embezzlements. He had been stealing for ten years before he was discovered. He used the money stolen to invest in an outside enterprise which failed. Then he tried to recover his losses by speculation in stocks and grain—with the bank's money, of course. During the period of his maneuvering a customer of the bank discovered that the cashier had removed $200,000 in bonds from the bank's account but this the cashier managed to explain satisfactorily to the customer and the bank and to cover up so that the bank examiners raised no question. He was given a sentence of twenty-one years.

Much ingenuity and planning is displayed by some defaulters. Others work very crudely. I am advised of a certain bank with its interest department, over the window of which was displayed the sign "Interest Department". No money was supposed to be taken in this interest department. The bank's system required that all interest on savings accounts should be calculated in the interest department and that depositors should present their books there to have the interest written up. One of the bookkeepers in the bank observed that frequently savings account depositors presented their deposits at the interest department window; that when the clerk regularly in charge of that window was on duty he would direct the depositors to the receiving teller. During lunch hour the bookkeeper would relieve the interest department clerk. If a depositor should happen to come in with a deposit during this hour the bookkeeper would take the money, enter the deposit and go through the motions of one calculat-

ing interest to make it appear to other clerks in the bank that he was doing just what the interest deposit clerk's duties required. After making an entry and returning the depositor's book, this bookkeeper would slip the money into his pocket. He would make out a deposit slip and later would enter the deposit to the credit of the depositor's account in the individual ledger. By doing so he kept the individual ledger account in balance with the depositor's book and in due course interest would be calculated and credited on the correct deposit. At this point, it appears the individual ledger would be out of balance with the control account in the general ledger. The bookkeeper always knew the exact amount he was out of balance and would doctor his sheets accordingly. If you should wonder how he managed to conceal this method of defalcation when the individual ledger was audited as it was several times over a period of two years by bank examiners and by outside accountants, I can say that the bookkeeper's method was very simple. When auditors came in they found the bookkeeper always accommodating and willing to aid them. He would volunteer his services. Inasmuch as the listing of individual ledger balances was a rather tedious process, the bookkeeper's proffered assistance was usually accepted. Sometimes he would call off the individual ledger balances to the auditor who would list them on an adding machine. At other times the auditor might reverse the operation himself calling off and the bookkeeper using the machine. Either method was satisfactory to this bookkeeper who knew at a certain examination that he was $15,000 short and that his ledger accounts would show that sum in excess of the control account. If the auditor were calling off, the bookkeeper would drop a thousand dollars now and then from his adding machine statement. In other words, the auditor's call of $3,000 would be put down as $2,000 on the machine and this method would be kept up until the whole amount of the shortage had been subtracted. If the bookkeeper were calling off he would drop a thousand at intervals so that the result desired by him would come about. The conclusion to be reached from a reported practice of this sort is that the accountant should not allow a man whose accounts are being audited to call off figures or aid in listing them on an adding machine. This bookkeeper's luck was satisfactory to him until the auditors came in while he was on vacation.

As you gentlemen well know, there may be a great deal of difference between an examination of a bank and an audit. It is said that many of the smaller banks throughout the country have often placed too much reliance upon the occasional visits of the National or State Bank Examiners, feeling that as long

as the final examiners make favorable reports or raise no serious objections, that their institutions are carrying on satisfactorily. Many of these banks have tried to avoid the expense of periodical audits which could be made by disinterested certified public accountants. Moreover, officers and directors of some of these institutions grow tolerant as the years seem to go by with reasonable success, and I have heard of instances where the principal officer in charge has grown actually generous at times when the clerical work was becoming unusually heavy—generous, I must say, without appropriate action of the board. In one bank located in an oil district it was found some time ago that the clerks were deluged with work and various kinds of paper. The bank had never before seen so much paper and cash. One late afternoon as the president passed a couple of his tired tellers, he volunteered this remark, "Boys, I know you're about snowed under with work,—if you feel that you need a little more money, go as far as you like." This happy remark of the president cost the bank $75,000—which the surety company had to pay.

Some of the members of your Society have had considerable experience, I imagine, in auditing for stock brokers. When the markets are exceedingly active irregularities are more likely to develop. According to developments disclosed in a case recently tried in the Supreme Court, it appeared that a number of clerks and employees of a stock brokerage firm conspired to defraud their employers in the following way. These employees, consisting of margin clerks, order clerks, floor men, bookkeepers, et al, undertook to deal in genuine customers' accounts without the knowledge of the customers and also in fictitious accounts. These accounts would be falsely credited with certain amounts and the amounts so credited would be used for trading operations. When the trading operations were successful the profits therefrom would be divided among the employees and the accounts of the genuine customers debited with the amounts of the profits so paid. In the fictitious accounts, the same system of false entries and false credits was employed. It was said that in some cases the genuine customers were in league with the employees and would share in any profits made; that where a loss occurred in a genuine customer's account the loss would be taken care of by manipulating the firm's stamp account, tax account and commission account; and by forged credit entries and forged debit entries and manipulation of accounts, the frauds of the employees were successfully concealed for a long period. I shall admit that the market's trend must have much to do with the success of such a method. While this was going on,

several auditors went over the books of this firm at various times without detection of irregularities. Finally the work of the employees was discovered by auditors who carefully and thoroughly checked up all the firm's accounts. The court when deciding the questions of law involved in the case, held that where cash and securities had actually been withdrawn from the firm by the dishonest employees the surety company involved was liable for the dishonest acts of the employees but further held that where the loss had occurred through trading in accounts the surety was liable on its primary bond but not on its excess bond for the reason that the liability of the surety for loss under its excess bond did not cover trading losses by employees in either genuine or fictitious accounts.

I understand that a committee of the New York Stock Exchange requires answers to be submitted to its members at least twice a year; that if these answers are prepared in the form requested they will reflect the financial condition of the answering brokerage firm on the date set in the notice. A principal requirement is that a stock exchange firm shall have a complete audit made of its books and records as of a date required by the Exchange, such audit to include a verification of cash in banks, money borrowed and securities pledged as collateral; a confirmation of all open trades and accounts with brokers; a list of all securities on hand (determined by a physical examination and count); statements to be prepared of customer's, partner's, firm's or other accounts appearing on the reporting firm's books. These statements are to be mailed or delivered with the request that a written confirmation of the account be sent to the auditors direct—not through the brokerage firm's office. I am advised that if this procedure had been followed by a brokerage firm that failed recently, its true condition would undoubtedly have been disclosed at the time of the audit. It is said that an audit of a brokerage house can only be made properly by an accountant and his own assistants who should be familiar with Street methods and who should accept no assistance from employees except as to the preparation of statements of account from the records for confirmation; that accountants should always be cautious about accepting assistance volunteered by a client's employees.

Cash in banks is easily confirmed and reconciled but it is extremely important to see that all deposits received by the bank were so received on the date recorded on the books of the brokerage firm. Open trades with brokers should be confirmed, then checked against the market and any material difference between these values and balances as shown by the

books should call for an explanation. Written confirmation of securities pledged as collateral are also readily obtained from the various depositaries. Securities shown as in transfer can be confirmed in writing by checking the transfer agent's receipts or by an examination of the new stock certificate when received (before it is signed or endorsed) particular attention being paid to the date appearing on the new certificate so as to determine that it was properly in transfer on the date of audit and not put in subsequently and immediately withdrawn.

Answers to the Stock Exchange questionnaires are to be prepared on a liquidated basis. The prices used to determine the value of the securities should be those on which the last actual sale was made, or bid price on the date fixed by the questionnaire. Fixed assets such as memberships, furniture, fixtures and so forth are usually taken at book value. Before filing their answers to a questionnaire the partners of a Stock Exchange firm should discuss the details with their accountant, I think, and in that I am sure you will agree with me.

Thoroughness in work and a complete sense of essentials to be covered by accountants seem to me to be fundamental. Some accountants may not think so. I will offer an illustration of the omission of the essential:

A concern engaged in feeding gangs on a railway line had its bookkeeper bonded by a surety company. Each of its foremen in charge of a group of men employed would send in a weekly time sheet covering employees of the insured, to the head office of the insured. Its bookkeeper would take these time sheets as sent in, and make proper entries in a time book. From the time book he would make up checks which he would have signed and handed back to him to be forwarded to the foremen who had sent him the time sheets, so that they could make payments to the employees. Over a period of four years, this bookkeeper had padded the time book by adding the names of dummy employees for whom checks had been made out. Thereafter the bookkeeper cashed the checks for the dummy employees at a bank in his city. In the course of four years, the bookkeeper secured about $40,000, notwithstanding the fact that the concern that employed him had quarterly audits made. In four years none of the auditors ever checked the original sheets of entry. They always started with the time book.

Too much confidence in various officials or clerks in banking and other institutions and a waiver of thorough and com-

plete audits have often left the ways open for severe losses. I have in mind another bank, west of here, that believed it had an almost perfect teller. This teller, under thirty years of age, was not only active in business but in the church. He was said to have had no bad habits and to be held out to the young men of the community as exemplary. He was with the bank I refer to twelve years before his default was discovered. This teller's first peculations began, it appeared, about the middle of the year 1920 when he was a bookkeeper in the savings department. At that time he charged several small personal checks to one of the control accounts of the savings department. He finally worked this practice up to express a sizeable shortage. After being promoted from bookkeeper to teller of the savings department, he was able to continue covering his shortage by assisting the new bookkeeper. Finally the defaulter undertook to make good his shortage by some outside ventures using in these, of course, the bank's funds which he obtained by forging withdrawal orders on certain savings accounts he knew to be inactive. The bookkeeping system used by this bank in its savings department was the ledger card system and in order to cover up his misappropriations the defaulter used two sets of ledger cards. One set reflected the true balances of the accounts, the other set the balances as they should have been. The first set he used for bookkeeping purposes and at the time when his accounts were being examined. Several ventures attempted by the defaulter to get even resulted in failure. By the year 1922 his shortage amounted to $60,000 and 1926 it was alleged to be still going up through abstractions of sums from $25,000 to $35,000 monthly. This teller's shortage was discovered by auditors, it appears, because the teller reported for work one morning about fifteen minutes too late and was without an opportunity to shift his card system and smother his shortage which then was claimed to amount to more than $450,000. After some direct questions were asked him the teller realized that discovery of his shortage was imminent. Retaining his composure he evaded a question or two of the examiners, took a few thousand dollars in cash from another teller's drawer and disappeared. While traveling from one hotel to another he found little cheer in reading of the $5,000 reward offered for his arrest and surrendered in a manner which saved payment of the reward. This defaulter's books were audited, I believe, about fifteen times by State and private auditors on whom he had worked successfully his card system.

Strange as it may seem to you and to me, audits are sometimes strained to fit a situation. I am told of a small concern which built up a very large and lucrative import business and which later sustained a large loss through the acts of an outside accountant. When this concern's business was small, its president had a friend who was an accountant and who for a nominal charge undertook to balance this concern's books from month to month. Notwithstanding the increased amount of work the accountant was called upon to do as the concern's business grew, he asked for no increased compensation. A time came when illness prevented this accountant from taking the usual monthly balance whereupon the president of the concern while glancing over cancelled checks of the previous month noticed some rather large checks which aroused his suspicion. Investigation developed that this accountant, during the years he was balancing the concern's books, had arranged with the concern's bank to hold the cancelled checks until he would call for them. It was found that the accountant had drawn several large checks to his own order on which he had forged the name of the president of the concern he was defrauding. When taking his monthly balance the accountant would, of course, take such cancelled checks and destroy them charging the amounts thereof on the concern's records to various expense accounts. This concern held only a very small forgery policy. Its president was keenly disappointed because of the accountant's unfaithfulness but he was of a worse state of mind when he found that no recovery could be made against the bank because of the destruction of the forged checks. It would have cost only a small portion of the amount lost for this concern to have had an audit by reputable certified public accountants.

It may interest you to know that we have also had claims filed against us by concerns for loss of securities, it being alleged that the last time the securities were known to have been at hand was on the date that auditors made an examination.

The increase in the number of frauds and defalcations during the recent years is due in a large measure to the rapid expansion of our industrial and financial organizations. This is the age of "Big Business". Concerns that formerly operated independently, we now find merged into one enormous corporation, under single management. It was possible for the proprietor of an individual concern to keep in touch with practically every phase of its business. In many instances, he was personally acquainted with the concern's customers, passed on

credits, reviewed the collections, and signed all checks. The active head of the present day corporation cannot devote much time to details. Of necessity he must delegate such matters to his subordinates. His time is largely occupied with matters of policy and management.

The volume of business transacted by these large organizations has grown to such an extent that the subordinates in turn have had to apportion their work among a number of clerks. While, of course, various controls have been set up, the fact that the work of these clerks is not subject to minute review by a superior has made it possible for those of weak character, when tempted, to embezzle funds of their employers and to cover up such peculations by manipulating accounts.

Furthermore, I am advised that the certified public accountant has been obliged, because of the size of the present day organizations, to often confine his audit to an examination of the assets and liabilities and of the Income and Profit and Loss Accounts, instead of making, as was the custom some few years ago, a general audit of the accounts, including a complete verification of all the cash receipts and disbursements. In other words, the certified accountant has had to rely, to a certain extent, upon the internal check, and if by chance this check were not properly maintained a shortage could exist which might not be discovered during the course of his audit. Our files are full of cases where an employee was able to pyramid his embezzlements without detection simply because the internal check was inadequate.

According to our experience an accountant when engaged by an assured to investigate a defalcation seldom, if ever, confers with a surety company during his investigation. Hence, it is often found that the accountant's report does not contain information required by the surety company concerned if and when claim is made on its bond. As a result the surety is often obliged to turn over to one of its inspectors a claim made against it for the inspector's investigation or to employ another accountant to reconsider the claim.

Not long ago, a claim was filed for $25,000, the full amount of an excess blanket bond issued by our Company. Investigation disclosed the fact that the assured placed the primary and excess blanket bond with a different company each year. The total shortage was in the neighborhood of $500,000. Naturally, the question arose as to when the various defaults occurred. There were some five or six companies involved in the primary bond and two other companies in addition to ourselves in the

excess bond. It can be readily seen that in a case such as this it is extremely important to trace each default back to the year in which it occurred, in order to determine the liability under the several bonds. Because of the excellent work of the accountant engaged by the surety companies, our Company was able to effect a settlement for $5,000.

Another point is this: It is the practice of surety companies to reinsure their risks, particularly large blanket bonds. Frequently, for one reason or another, a reallocation of reinsurance is made after the bond has been in effect a year or more. Under the reinsurance agreement, the reinsurer is liable for any undisclosed losses discovered within one year after the cancellation of the reinsurance. At the expiration of one year, the new reinsurer takes up the back liability of the previous reinsurer. While the assured is not interested in the reinsurance arrangement, and, therefore, is not concerned with the dates of the defaults, so long as the defaults occurred during the currency of the bond, the surety company, on the other hand, is particularly interested in this phase of the claim in order to properly allocate the loss to the various reinsurers.

Whenever we have had occasion to employ outside accountants to investigate a claim we have found the best results have been obtained where we have submitted to the accountant a questionnaire covering the particular points we desired to have investigated. If this practice were followed generally, it is believed that the accountant's reports on defalcations would be more in line with the requirements of the surety companies.

Recently, surety companies have had to entertain a good many claims under their bonds which grant protection to banks against larceny. These claims often grow out of the cashing of checks by depositors against what are termed "uncollected funds". In other words, a depositor will lodge with a bank checks duly endorsed and which are drawn on banks in other cities. This depositor may have little or no amount actually to his credit in his own account but in view of the deposit credit shown by the checks lodged with it for collection, the depositor is permitted to cash checks. This practice often discloses a check kiting scheme which may show a substantial loss to the accommodating bank when some of the foreign checks used are finally turned back unhonored to the accepting bank. Sometimes such a disclosure will come after several years' business relationship between a bank and its depositor, the bank, we would say, seeming to go on the pre-

sumption that because many checks of the depositor, on foreign banks, had gone through all right that all such checks of his should be unquestioned. With any such development and claim against the surety whose bond the bank holds, all facts and practices must be examined into seriously. It may appear that the officials of the bank claiming have had full knowledge and approved of the practices in vogue with its depositor; that the bank has been willfully careless or that it has intentionally extended credit to its depositor. Naturally such a bank should not expect a surety to make good for loss in consequence of such a practice indulged in by it with its depositors.

There are many forms of frauds and defalcations to which my attention is frequently directed that would not be of special interest to you as accountants. These frauds are sometimes accomplished by incorrect financial statements and by various other misrepresentations that are relied upon.

In conclusion, may I say that I find no element of society exhibiting greater shelfishness and conceit than the element that resorts to frauds and embezzlements. These offenders may very properly be termed parasites that feed upon the industry and savings of others. Years ago they were inclined to play the lone hand. Now we sometimes find that they too believe that "in unity there is strength" because they often work in groups. Among them are the conscience hardened, and those of supreme ego who, notwithstanding all the disclosures published and sentences served throughout the years, still believe themselves clever enough to avoid detection.

DETECTION OF FRAUDS AND DEFALCATIONS*

By NORMAN J. LENHART, C.P.A., of
Lybrand, Ross Bros. & Montgomery

THE detection of fraud is an important function of the public accountant, although it is true that he has become more and more concerned with constructive work in connection with accounting and management together with business advice along many lines. Nevertheless, if the detection of or prevention of fraud were to be eleminated as one of the underlying reasons for retaining the public accountant's services, there would be a substantial decrease in the scope and volume of his work.

Financial Statements

It may be said that the public accountant's signed certificate on statements of financial position and earnings should be an assurance against misrepresentation and fraud in the statements themselves. If the lenders of money and the general public were assured that statements issued by borrowers or by companies which sell securities could be accepted at face value there probably would be much less demand for the accountant's services. Even though the form of presentation of financial statements and many other questions in connection with the determination of the financial position and income account now engage the attention of public accountants, yet many of these matters would no doubt be handled in some other manner if full reliance could be placed on companies' own statements.

The usual understanding of fraud, as related to accountancy matters, includes not only theft, embezzlement, defalcation, forgery, etc., but also a false showing on the part of an enterprise for the purpose of selling securities, obtaining loans, securing an advantage on the part of officers or directors as opposed to the stockholders, etc.

Insofar as false or misleading statements are concerned, it hardly seems that much need be said here, since in the long run the detection of or prevention of such frauds in the case of audited statements rests upon the ability and integrity of the public accountant. A number of cases might be cited, in connection with statements made to the public by an enterprise, which many readers would loosely claim as fraud, but

* A paper read before the Eighth Annual Fall Conference of The New York State Society of Certified Public Accountants, New York City, October 20, 1930.

in which there may be no actual legal fraud but rather an attempt to make the reader accept a statement for something it really is not. In some few cases, the accountant, in attempting to meet the wishes or ideas of the company or its bankers, and at the same time trying to avoid any accusation of misrepresentation on his part, has prepared and signed statements which to the ordinary reader, without any great amount of technical knowledge, almost amount to misrepresentation or fraud.

A committee of the Robert Morris Associates has stated that some day, maybe, some accounting firm will come forward with an announcement that when their signature appears on a statement it will not be necessary to read the certificate or the comments, looking for the joker. This committee further said that in the meantime, and it will doubtless be a long meantime, the banks should keep distinctly in mind that this is not a one-sided affair, and as long as they do not insist upon their clients submitting to a real audit, which, incidentally is as beneficial to the client as to anyone else, they are, so to speak, compounding a felony.

Ability of Staff

The two major classes of frauds, which may be encountered in the ordinary course of the public accountant's work, are those perpetrated by the management and those by employees of a business enterprise. It may not be that business men or employees who perpetrate fraud are more clever than those of former days, but it is undoubtedly true that business conditions today offer many more opportunities for manipulation, misrepresentation and fraud than did those of former times. Furthermore, with accounting practice as it is today, it is increasingly difficult for the principals of a large firm of public accountants to keep in close contact with and exercise supervision over the work of the members of its staff. If all examinations or audits were conducted by men of the ability of the leaders of the profession, there would be little point to any discussion of this kind as to the prevention of frauds, since the ability of these men would be such that a large portion of frauds would be prevented or discovered. I believe the most important point which can be made in this discussion is the improvement of the ability and control of members of the public accountant's staff.

I am sure most firms of public accountants have recognized this fact, and many methods have been devised to meet the situation. Nearly all firms have careful supervision exercised by their seniors over the junior members of the staff and, in

turn by the partners over the seniors. It would be quite difficult, in a review of an audit, to make certain of the degree of skill exercised in matters other than those apparent from the working papers or from discussion with the senior. It follows, therefore, that accounting firms must rely to a large degree upon the ability and integrity of their representatives, and it is most satisfactory to note the relatively few instances of frauds or defalcations which have been overlooked by public accountants and which should have been caught in the work of the scope and limits in question. Most large firms have experimented with or have adopted either general or specific audit programs, audit questionnaires, etc., all designed to improve the standard of the audit and to make certain that insofar as is possible the staff's representatives have covered all features of the work and have exercised the skill and care which would have been exercised by the principals of the firm if they were personally conducting the details of the audit.

Under present conditions it requires a much higher order of skill on the part of the senior properly to conduct an audit than it did in the days when the bulk of audits were of concerns much smaller in size and with many less complexities involved. Modern conditions have brought up the same problems in other professions, such as in law. In the last named profession the situation has been met by specialization; many attorneys engage in only one branch of legal work. The public accountant, on the other hand, is hardly able to specialize in only one field and attain to a practice of any considerable size. It is true that there are some few firms who specialize in one field or another, but even those firms will ordinarily accept engagements covering other fields of work.

Perhaps one of the most successful methods of meeting the situation with respect to the ability of the staff, is the establishment of schools in the public accountants' offices. Usually these schools take college graduates and agree to keep them on the staff for a period of three years, during which they receive training. Most of the men so employed have taken all of the accounting courses offered at college. In the case of my own firm, these men are put through an intensive course of training for the first four months, during which time they do nothing whatever but study, work problems, listen to lectures, etc. After this period is over, these men are assigned to minor work, and insofar as is possible, their work is followed up. Those that show particular promise are pushed ahead as rapidly as possible in order to give them full opportunity to develop. In the case of those that show particular defects, an attempt is made to overcome and cure their weak-

nesses. It seems to me that this method of taking on college graduates and giving them intensive training offers the most promise of success in developing the general ability of the staff. Most of the larger law firms take few, if any, men on their staffs who have not received college or university training.

Examples of Frauds, General

It may be of some interest to outline a number of actual cases of fraud and to state generally the manner in which such frauds would have been or were detected by audit of the accounts. A great many frauds have come to light recently, and without any question, a large number of frauds have been or are being perpetrated without disclosure. Considerable cleverness is shown in the manner in which many of these frauds have been effectively concealed for varying periods of time. The possibilties for the perpetration of fraud seem almost without limit. Usually fraud is concerned with the misappropriation of cash, either by the failure to account for cash receipts, or by the entry of payments which are fictitious in whole or in part. The manipulation of cash receipts and disbursements may involve the misstatement or manipulation of almost any asset, liability, income or expense account. The detection of fraud with regard to assets other than cash offers a rather more difficult task. Too much reliance should not be placed upon the system of internal check. Almost any such system relies upon the division of work and the necessity for collusion in order that successful fraud may be perpetrated. The most favorable opportunity for fraud exists when one employee has access to or control of all phases of an entire business transaction. Fraud is made much more difficult if it is necessary for two employees to be in collusion but cases are not infrequently found where the two employees necessary have gotten together and have been guilty of fraud.

It is certain that all of these frauds would not be disclosed by an examination of the balance sheet. Many frauds have been uncovered of late which could not conceivably be disclosed by an examination restricted to the assets and liabilities as at a particular date. It seems to me that the tendency toward the so-called balance sheet examination which embraces limited tests of income and expense tends to operate against a disclosure of clever frauds.

Duplication of Loans

A somewhat unusual case of fraud occurred in a midwestern city quite recently. This fraud was one perpetrated by the management of the company and would almost cer-

tainly have been disclosed by an audit. Unaudited financial statements were submitted to banks regularly by the company and were signed by its president. The fraud was disclosed immediately following the suicide of the president of the company. The bankers involved found that they collectively held a much larger amount of notes of the company than were shown on the company's statements. For purpose of illustration, it may be assumed that the company's statements showed $200,000 bank loans and that it had this line of credit at several banks. It had been the practice of the president of the company to make a bank loan and to have the proceeds paid to the company by checks or drafts which were endorsed by the president and used to buy drafts payable to other banks or individuals. These purchased drafts were diverted to the personal use of the president, the loans themselves not being entered on the books. The amount of loans on the books aggregated an amount equal to or more than the loans from any one bank, so that any banker receiving the company's statement assumed that the major portion or all of the bank loans shown were from his bank. Since the undisclosed loans were made from banks with which the company regularly did business, an auditor in confirming the cash would, of course, have inquired as to liabilities and the duplication of loans would thus have been disclosed.

Checks Countersigned in Advance

Another case of fraud, which was disclosed by a first audit, occurred with an interior decorator in New York City. The owner of the business was away from New York during a large part of each year in connection with the purchasing of various items sold by the business. A counter signature was required on all checks, but it was the practice of the two persons authorized to countersign to sign blank checks in advance so that the cash and accounts were absolutely under the control of the cashier who had been with the concern since its inception and who was not bonded. There was no particular occasion on the part of the owner of the business to have an audit made, but it was felt that inasmuch as the business was growing, it might be well to have the accounts looked over. No fraud was discovered through an examination of assets and liabilities, but upon making test checks of the income account it was found that the cashier had obtained cash through numerous checks drawn to the order of cash or himself which he entered on the records under the names of various creditors, and charged to expenses, purchases, etc. There was a rather amusing consequence to this case in that the

employer who suffered the loss related the circumstances to a woman who was a competitor in the same line of business. This woman did about twice the volume of the employer who suffered the loss, and immediately concluded that if $50,000 had been disclosed in the first case, then she no doubt had lost $100,000, inasmuch as she did twice the volume. She expressed her disappointment in no uncertain terms when her employees were found to be honest.

Brokers' Offices

Numerous frauds are being uncovered in brokers' offices. A case recently came to light in which at least seven employees were involved, although not more than two were involved in each fraud being carried on. The firm carried the usual transfer suspense account in which were recorded securities received for which there was not sufficient information to show to whose account they should be credited. Two clerks decided that they could take securities which had remained in this account for some time and escape detection. If the account was long, say, 20 shares of a certain stock, and the box contained 20 shares, then this number of shares would simply be abstracted and entries made charging transfer suspense and crediting the box. If the box did not contain the exact number of shares, the transfer clerk would put a certain number of shares, say 60, in transfer, to be split up so that there would be a 20 share certificate coming out, and would take the new certificate for say 20 shares and would return to the box the certificate for the balance of 40 shares. An entry was properly made showing the number of shares in transfer. When the shares were returned from transfer, the transfer received blotter showed 60 shares coming in from transfer but only 40 were actually placed in the box. The blotter summary sheets from which postings were made to the security record were falsified at this point to show only 40 shares received from transfer and put in the box. The transfer account would then be out of balance by 20 shares. An adjustment without supporting entries of any kind was then made crediting transfer and debiting transfer suspense with the 20 shares, thus placing the accounts in balance.

The stock dividend account was used in a similar manner by other employees. If, for example, the dividend account was long 10 shares of a certain stock, an entry would be put through to deliver these 10 shares to transfer for another house, apparently on account of dividend claim. No record appeared in the office of this stock coming back from the

transfer agent in the name of the other house, and it developed that the stock had been sold by another firm for an account belonging to one of the men involved in the fraud.

Losses of the foregoing type can be effectively controlled only by making certain that securities are received in such manner that they must be recorded on the books of account and in the proper accounts and the requirement that all deliveries from such accounts as transfer suspense, stock dividend, etc., be supported by written authorization by a member of the firm. If this method of internal check is not followed, it is extremely doubtful whether losses of this kind would be revealed in the course of a security examination. A detailed examination which included the verification of such accounts and examination of supporting documents would detect such shortages, but the major portion of examinations of Wall Street houses are not detailed audits.

The same Wall Street firm suffered losses through operations of two other clerks. If, for example, shares were received from another broker for which $5,000 should have been paid, a check would be drawn for $6,000, and the overpayment of $1,000 would not be charged to suspense account as it should have been pending adjustment, but was charged to interest expense account. The clerks would then request a refund from the selling broker on account of the overpayment and the check, when received, would be credited to an individual account which had apparently been opened for this purpose. Cash withdrawals were subsequently made and charged to this account.

This same firm maintained thrift accounts for employees. When deposits were made by various clerks for credit to their respective thrift accounts an employee would pocket such funds and put through a charge to interest account to offset the credits to the employees' thrift accounts.

Still another clerk followed the method of using borrowed stock to obtain cash. If 100 shares of stock were borrowed from another broker, the payment to secure such stock was charged to interest expense account rather than to stocks borrowed. When the borrowing broker returned the 100 shares of stock he would receive a check for the amount originally paid, say $1,000, and this $1,000 would be credited to the account of the employee's brother. Subsequently, cash withdrawals were made against the brother's account.

The last three mentioned frauds would be disclosed ordinarily only by detailed examination of the interest account.

It is sometimes possible, however, for a partner of the firm to obtain a rather close control over the interest account during a period when the interest rate is not varying rapidly. The partner knows each day the amounts upon which interest is computed and can figure with reasonable accuracy the amount which should appear in the interest account each month. This type of fraud is particularly easy to conceal since the interest account of many firms contains a large number of transactions. Here again the only sure remedy is a detailed examination.

Weakness of Bank Reconciliation

Another case came to light recently in which the cashier who had been in the employ of a company for 20 years was authorized to countersign checks. The cashier was a woman who had never shown any particular signs of prosperity but it was found that she took cash in various ways. One plan operated by the cashier was made possible by the fact that the company maintained a check register showing numbers and amounts only of checks and kept three cash payment books, one for merchandise, one for freight and a third for expenses. Upon one pretext or another the cashier was able to obtain an occasional signature before the check was filled out and these checks were drawn to the order of the cashier and were charged to expense of one kind or another. A separate clerk independently received paid checks and bank statements at the end of the month and reconciled the bank balances. However, this clerk made the reconciliation from the numerical record of checks without any comparison of payees' names with the three cash books. It is quite difficult to understand how the clerk who reconciled the bank balances could have avoided being struck by the number of times the cashier's name appeared as payee, but apparently no attention was paid to the payees' names. The accounts of this company had been audited for some time, and this particular fraud was discovered in the second year of its operation through the rapid growth of the freight expense account and an investigation as to the reasons for the increase. It appears that the reason the fraud was not discovered at the end of the first year after the cashier was authorized to countersign checks was that a great deal of pressure was put on the auditors to hurry the report, and the bank reconciliation was made with the check register, which did not show check names. Furthermore, there were no outstanding checks in the name of the cashier, as very few were issued during the last month. This cashier also obtained company checks from the plant office in exchange for her

personal checks, giving various plausible reasons. When the plant cash was received at the head office these personal checks were destroyed by the cashier and false footings were made in the cash books. Other thefts were not concealed, and caused differences between the accounts receivable control and the detailed customers' accounts which differences were later written off. All of the thefts in this case would have been discovered by a thorough check of the details of, say, one month's transactions. The audits which had been made were of the balance sheet only.

Manipulation of Cash in Bank

In connection with the audit of the mid-western office of a large stock brokerage house, a bank shortage of over $150,000 was discovered by checking the daily deposits per the books with the deposits shown by the bank statements and the withdrawals as shown by the books with paid checks as shown by the bank statements. The employee's procedure in this case was to take cash from the bank by means of his authorized signature. The company had some 40 bank accounts and at the end of each month checks would be drawn on certain banks and deposited in other banks to cover shortages. The checks so drawn would not be entered and would not be shown as outstanding. This theft was discovered upon the first audit of the accounts of the company, but had been in existence for many months. Unless such detailed comparison of deposits and withdrawals is made, or else unexpected bank reconciliations are made as at the date of the audit, it is quite difficult to catch this sort of theft.

Another rather interesting case was that of the cashier of a large company which operated a retail business with a number of branches in a large city. The cashier never took a vacation, except one afternoon a week during the summer months, on which occasions he attended the races and spent what money he was able to obtain through his manipulations. Although this cashier stole over $100,000, there could have been no indication of such theft from his manner of living. He owned a secondhand car, dressed poorly, and appeared to be living within his salary. Although credit was extended to customers, a large portion of the merchandise was paid for over the counter in cash or by check at the various branch offices or at the central office. Cash and checks received at the branch offices were deposited in nearby banks. The branches were not permitted to draw funds from these banks, but at various times during the month amounts were trans-

ferred by the central office cashier to the central office bank account without any entries being made in the accounts. Each month the branch cash sheets showing the amounts of daily sales and daily deposits with supporting data were checked by another clerk, and the amounts were traced by this clerk to the deposits in the branch bank pass books. Cash in branch banks per the records, equal to the net amounts of the branch sales for the month was transferred to the general office by the defaulting cashier in part during the month and the balance during the following month and these amounts were entered by him in the general cash books as proceeds from branch sales of the month. During each month the cashier took money from the daily central office sales. These current and past central office shortages were made good by the deposit at the central office of the amounts transferred to the central office from the branch office funds during the month but not entered on the records and of course the checks transferring these unrecorded amounts from the branch offices were not entered in the branch cash books. In some cases, transfer slips were used which were honored by the branch banks. From all outward indications the branch bank accounts were used to accumulate all receipts of each branch, and these receipts were transferred during or at the end of each month, leaving no balances in the branch banks from the previous month's transactions. The cashier, however, allowed sufficient time to elapse before each recorded transfer or at the end of each month so that he could withdraw from each branch bank an amount sufficient to cover the previous month's business, the shortage in reality being made up out of the branch transactions of the succeeding month. This shortage was revealed by the fact that the branch cash sales decreased to the point where the cashier was unable to obtain sufficient funds from the branches early in the month to make good his past shortages.

Variations of this method may be encountered in many cases. Stores which maintain cash funds at various points may lose funds through appropriations of certain amounts and the making good of these amounts from the following day's sales before the cash is turned in. Chain stores offer an opportunity of obtaining money in the same manner. In order for an auditor to be certain of catching any such frauds, together with any frauds which may be covered up by transfer of funds from one point to another, there should be representatives present at each point at the same time in order to make cash counts, and bank confirmations should be sent out in the case

of every bank used, regardless of whether the previous month's balance has presumably been entirely checked out. It would also be necessary to reconcile back to the date of audit in the event the cash count is made after the effective date of the audit.

Outstanding Checks Dropped

Several cases have come to light recently in which cashiers who have had access to the company's funds in bank have taken money by means of checks and have covered up the shortages by dropping old outstanding checks out of the bank reconciliations. If the company's bank reconciliation is checked back to only a relatively recent date, it is quite difficult to detect such frauds. The Federal Reserve Bulletin on Verification of Financial Statements states that there is only one safe and satisfactory method of proving the accuracy of the list of outstanding checks, and that is to compare the credit side of the cash book from the last day of the fiscal period backward item by item with the checks returned from the bank for whatever period may be necessary to account for all current outstanding items. In order to conclusively prove the outstandings, it is really necessary to account for all check numbers since the date of the previous audit. In many instances this would involve the expenditure of a great deal of time and perhaps fees running up to several thousand dollars on this one feature alone.

Manipulation of Profits on Investments

Another case occurred in connection with a company which kept its investments in a separate investment ledger. Profits on investments sold were periodically transferred to the profit and loss account in the general ledger. The footings in the investment ledger, however, were forced and lower profits were shown than were actually made. The amounts of profits transferred, as shown in the investment ledger, agreed with the items in the general ledger profit and loss account. The balances of profits corresponding to the amounts by which the footings were forced were credited to the account of an employee. This would seem to be a rather difficult fraud to catch, unless a certain amount of reviewing and detailed checking of general ledger and important subsidiary ledger entries and footings was performed. The employee in question was not supposed to have control of both ledgers, but in the course of years, and through intimacy with the other clerks, the work had been gradually interchanged to the extent that it finally permitted him to make and conceal these manipulations.

Bankrupts

A great many frauds are perpetrated, principally upon creditors, by small businesses which become bankrupt. The cure for many of such frauds is the insistence upon statements prepared by a competent auditor, but at the present time at least there is no such general insistence. Most of the fraudulent statements prepared by small concerns for the purpose of misleading creditors contain misrepresentations of inventory. Many statements are made by bankrupts, sometimes under oath, which can be disproved from the bankrupts' records. In one instance the bankrupt under oath testified to the nonexistence of any merchandise inventory at a particular date. Examination of the records disclosed that goods had been sold after this date in the original bales or containers and by matching up with the purchase invoices previous to the date in question, it was proved that a substantial inventory existed at the date the bankrupt claimed he had no inventory. A careful scrutiny of purchase invoices and checks may very often lead to a clue covering the purchase of assets subsequently hidden. Purchases are often charged to expense accounts, and reference should be made to all supporting documents for the various expense accounts. Instances are quite often noted in which a company, in anticipation of request for a statement, enters sales shortly prior to the date of requesting a loan, thereby increasing accounts receivable and profits. Many instances have also been found where numerous credits have been passed to accounts receivable representing alleged returns of merchandise. Correspondence with customers has shown that the customers have paid for the merchandise in cash, but that the cash had been taken by the owners of the business and credit memos put through to cover the appropriation of funds.

It has been found by recent experience that even a somewhat superficial examination by an accountant is of great assistance in uncovering frauds on the part of bankrupts. In many instances the accountant is able to indicate certain items which should be the subject of special inquiry and a substantial amount of assets has been recovered with a relatively small expenditure of fees for the accountant's time.

General Considerations

In connection with various types of fraud and defalcation, I would like to call attention to a book which has just been published under the auspices of the American Institute of Accountants. This book is by Mr. George Bennett and is

entitled, "Fraud, Its Control through Accounts". Various textbooks and books on accounting subjects refer to methods of fraud, but there does not seem to be a very extensive literature on the subject. The bulk of frauds seems to be concerned with abstraction of cash or securities. There are, no doubt, many frauds and thefts by storekeepers and others having custody of materials or by individuals who do not have such custody. Such thefts are detected readily only if extensive and accurate stores records are maintained.

It seems obvious that the so-called balance sheet examination is not apt to catch many frauds. The Federal Reserve Bulletin entitled "Verification of Financial Statements" deals with an examination which includes a verification of the assets and liabilities of a business enterprise at a given date, a verification of the profit and loss account for the period under review and, incidentally, an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check. This Bulletin, however, states that the procedure outlined will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts. While adequate internal check is desirable, it is apparent that with the many cases of collusion which appear, too much reliance cannot be placed upon the fact that the work of one employee dovetails into or is checked by the work of another. Comparisons of expense items by periods often indicate variations which should be examined into. In the case of a balance sheet audit, many firms of auditors now bring particular attention in their reports to the facts that such an examination cannot be considered to be a detailed audit nor a review of all transactions and for that reason cannot be expected to disclose all or even a major portion of any irregularities in the accounts during the period.

In times such as these it seems highly desirable for accountants to emphasize to their clients the desirability of some more detailed examination of the income account and supporting records than has perhaps been made in the past. This detailed work could well be done before or after the busy season, with perhaps more effectiveness than at the time of the regular audit.

THE ACCOUNTANT'S LIABILITY FOR FAILURE TO DISCOVER FRAUD *

By John R. Wildman, C.P.A., of Haskins & Sells

LOGICAL consideration of the subject of "Detection of Fraud and Defalcations" must of necessity recognize the fact that such irregularities are an ever-present matter of concern to the accountancy profession. Such consideration must include also some general classification of irregularities, and of the manner in which they are perpetrated and concealed. Further, attention must be given to the auditing procedure by means of which various irregularities may be detected. But, to make the consideration of frauds and defalcations comprehensive from the viewpoint of the public accountant, his position in law and his liability must be considered in the event that he fails to discover irregularities existing in any of his professional undertakings.

Turning to the law affecting the public accountant and his liability, one finds no statutes and a paucity, in this country, of decided cases. Such cases as there are, like most English cases, cover generally litigation arising between accountants and their clients. Disputes as to the rights of third parties are represented by two cases—one in Pennsylvania and one in New York. The Pennsylvania case was decided in favor of the accountants, who had been charged with negligence, because it was held that the accountants had no contractual relationship to the claimant and, therefore, no duty to him. The New York case [†] in which the facts of the situation are quite different, was decided by the Trial Court in favor of the accountants on the grounds of lack of privity, but was reversed by the Appellate Division, First Department, of the Supreme Court of the State of New York, which recognized a duty of the accountants to third persons, regardless of contractual relationships.

In the New York case the Appellate Division, apparently having no New York precedents affecting accountants, seems to have reasoned by analogy from the duties of those engaged in other lines of endeavor. Perhaps the outstanding of these

* A paper read before the Eighth Annual Fall Conference of The New York State Society of Certified Public Accountants, New York City, October 20, 1930.

† *NOTE. The final decision has not been made of this case, as this* Bulletin *goes to press, and for that reason opinion should be reserved as to its scope and effect.*

cases assumed to be analogous is the one known as Glanzer v. Shepard, 233 N. Y. 236 (1922). In that case a public weigher erred in reporting the weight of beans to a third party known to him and to whom he was instructed to report the weights, so that the third party, under a contract, claimed damages for overpayment of amounts in the settlement for the goods under contract. In that case the court held that the weigher had a duty to the third party, had breached his duty, and the third party, relying on the report of the weigher, and having been damaged, was entitled to recover from the weigher.

Another case which seems to have been assumed as being analogous is International Products Company v. Erie Railroad Company, 244 N. Y. 331 (1927). In that case inquiry was made by the plaintiff of the Erie Railroad Company as to the location of certain goods which he desired to insure against fire. The railroad company replied that the goods were located in Warehouse A. The goods were insured as being located in Warehouse A, but as a matter of fact they were in Warehouse B, which burned, and the goods were destroyed. The plaintiff, having failed to collect from the insurance company, sued the railroad company and recovered, the court holding that the railroad company had a duty to the plaintiff; that in giving the plaintiff inaccurate information as to the location of the goods, the railroad company had breached its duty; and that the plaintiff, having relied on the statement of the railroad company and having suffered a loss, was entitled to recover.

One further case which seems to have had some bearing on the decision by the Appellate Division of the New York Supreme Court is Doyle v. Chatham & Phenix National Bank, decided by the New York Court of Appeals May 6, 1930. In this case Doyle was a purchaser of bonds issued by an automobile finance company and authenticated by the bank in question. The bank, as trustee, certified that the bonds were of a series secured under the provisions of a certain trust indenture. The indenture provided that the bonds should be secured by deposit with the trustee of trade acceptances or notes of dealers, guaranteed by the Motor Guaranty Company, cash or notes of purchasers in part payment for motor vehicles or other first lien mortgages. The indenture further provided that the trustee might require from time to time that the corporation furnish a certificate of the president or a vice-president, attested by the secretary or assistant secretary, under the corporate seal, concerning the names and addresses of

makers, acceptors and other pertinent data regarding such collateral and/or first lien mortgages, such lists, descriptions and tabulations of collateral delivered or to be delivered to the trustee. Further, it was provided that "such certificate or certificates shall be conclusive evidence to the trustee of all statements therein contained, and full warrant and protection to it for any and all action taken on the faith thereof under the terms of this indenture."

It appears that the collateral deposited at certain times did not agree with the specifications required by the trust indenure, and that the bank failed to obtain certificates necessary for its protection. Doyle, having purchased bonds, the issuing company having failed, Doyle having suffered a loss, sued the bank and recovered. The court here held that the bank had a duty to Doyle, or to any other holders of bonds in due course; that the duty had been breached by failure to require proper collateral, or in lieu thereof, a certificate, and in inaccurately certifying.

These cases are cited, not for the purpose of arguing the law relating to the practice of accountancy, but to point out that the present law in the State of New York, in so far as it affects the liability of accountants to third persons, seems to be predicated on the principle that if an accountant makes a statement for the purpose of being communicated to a third person, or intending that it shall reach and influence a third person, he can be held, even though he may have no contractual relationship with that person. Such action on the part of an accountant seems to have been interpreted by the Appellate Division of the Supreme Court of New York as an implication of a duty by the accountant, which duty, if breached, gives rise to a cause of action against the accountant. The Appellate Division seems to hold further, in so far as the majority opinion is concerned, that the third person need not be known to the accountant at the time the statement is made, nor is the damaged person required to prove that he relied solely on the statement of the accountant.

The attitude of the court in the particular New York case in question is summed up in the following quotation:

> "The general principle involved and upon which plaintiff relies for the imposing of liability is that if one undertakes to discharge any duty by which the conduct of others may be governed, he is bound to perform it in such a manner that those who are thus led to action in the faith that such duty will be properly performed, shall not suffer loss through improper performance of the duty, or neglect in its execution."

Thus, as a matter of present law in this State, it appears that an accountant, under the circumstances above mentioned, may be held for negligence in tort, regardless of his contractual relationships.

If the foregoing statement is correct with regard to the law on the subject in New York, third persons, without contractual rights, but under the afore-mentioned conditions, may enjoy the same standing in court as those parties with whom the accountant enters into a contract, and the account's chief concern in all his undertakings is to avoid the taint of negligence.

What constitutes negligence may be defined easily in general terms. What constitutes negligence under the circumstances surrounding a particular case is a matter more difficult of determination.

> "Degrees of Care: In the civil law, there are three degrees of diligence: Ordinary diligence, diligentia; extraordinary diligence, exactissima diligentia; and slight diligence, levissima diligentia; and it has been said that the distinction of degrees of care, skill, and diligence required in the performance of various duties and the fulfilment of various contracts is too firmly settled and fixed in the law to be ignored or changed. The distinction is accordingly recognized in some jurisdictions where degrees of negligence are recognized. A duty to exercise great care or the highest degree of care may be imposed by statute or may result from contract relations, or, on the other hand, the situation may be such as to impose a duty of slight care only. However, in the ordinary case of negligence, involving no statutory regulation or contractual obligation with respect to the degree of care, there is a strong trend of judicial opinion against recognizing any classification of care into degrees, corresponding to the tendency to refuse to recognize the existence of the degrees of negligence, the view being taken that whatever degree of vigilance, caution, and skill the circumstances may demand, the exercise thereof is merely ordinary care."
>
> "* * * The usual test of the duty of one person toward another or the property of the latter is ordinary care, or as it is sometimes termed, 'reasonable care', or 'due care'." (45 C. J. 680-682).

The United States Supreme Court's definition of negligence is shorter and perhaps easier to understand, to wit:

> "Negligence is the failure to do what a reasonable and prudent person would ordinarily have done under the circumstances of the situation, or doing what such a person under the existing circumstances would not have done." (Railroad Co. v. Jones, 95 U. S. 439-441).

Quoting further on the subject:

> "It would seem, however, that if one, assuming a responsibility as an expert, possesses a knowledge of the facts and circumstances

> connected with the duty he is about to perform, and, bringing to bear all his professed experience and skill, weighs those facts and circumstances, and decides upon a course of action which he faithfully attempts to carry out, then want of success, if due to such course of action, would be due to error of judgment, and not to negligence." (The Tom Lysle, 48 Fed. 690, 693, and Staloch v. Holm, 100 Minn. 276, 280.) "* * * But it is not necessarily negligence to fail to reach, on a doubtful question, the same result that a court reaches after carefully weighing the conflicting opinions of equally honest and competent witnesses." (Boston, etc., Canal Co. v. Seaboard Transportation Co., 270 Fed. 525, 529).

The technical procedure to be followed in the auditing of accounts is far from being well settled. In the present stage of the profession's development, there is scarcely such a thing as standardized procedure. Current procedure is governed largely by individual opinion and judgment under the circumstances of each particular case. Consequently, there may be wide differences of opinion as to what constitutes proper procedure. By the same token, it is equally difficult to determine what constitutes negligence. There is little in the way of authoritative statement which serves as a basis of judgment on this point. Except as definite procedure has been established in certain scattering instances, as the result of study and research with respect to certain phases of auditing work, it is difficult for any one to state what course would be followed in a given situation by the average man possessed of adequate skill and exercising due care. Too often the questions of care and diligence hinge on an auditor's success or failure in detecting irregularities which have been ingeniously planned, executed, and concealed. Consequently, the detection of such irregularities results, not from the exercise, by the auditor, of reasonable care and diligence, but from the use of hyper-skill and individual cleverness which surpass the shrewdness of the perpetrator.

Two incidents will, however, probably serve to illustrate the difference between negligence and lack thereof. The first incident had to do with an audit for the fiscal year ended June 30, 1925. The audit work was commenced on July 11, at which date the cash in hand was counted, the bank account was settled, and the balance was reconciled with that shown in the cash book. The bank settlement included only checks paid by the bank during the period from June 30 to July 11. In reconciling the bank balance, the accountant scrutinized the returned checks carefully for evidence of forgery and irregular endorsements, and compared the amounts of the checks with the cash book entries. In making this examina-

tion and comparison, the accountant found fifteen checks which were irregularly drawn and entered in the cash book as follows:

(1) Drawn to the order of the bookkeeper (who also acted as cashier) and endorsed and cashed by him; entered in the cash book either in the name of the bookkeeper or under some other name.

(2) Drawn to the order of a payee other than the bookkeeper, endorsement forged, and then endorsed and cashed by bookkeeper; entered in the cash book either in the name of the payee or under some other name.

(3) The amounts of certain checks were split up and entered in the cash book under several different names and in several amounts. In one instance there were seven entries covering one check.

The payees of the above checks, other than the bookkeeper, were in some instances actual suppliers, to none of whom the company had any liability, and other payees were entirely fictitious persons. In the case of a few checks the signature had been forged by the bookkeeper. The postings from the cash book had not been made.

The accountant detected the foregoing irregularities, except the forged signature, and called them to the attention of the bookkeeper, who explained that he had become confused in making the entries in the cash book, and then proceeded to change the entries in pencil so that they were in agreement with the payees and amounts of the checks. The accountant accepted the explanation given by the bookkeeper and did not make any further investigation.

Shortly after the completion of the audit a shortage in the cash was discovered by the client, and an examination was made of all checks issued during the employment of the bookkeeper, which began during the fiscal year ended June 30, 1925. No evidence of further irregularity was discovered. It appears that the bookkeeper commenced his irregular acts on July 1, probably feeling safe in doing so after the close of the fiscal year.

With so many evidences of irregularity, such as forged signatures, fictitious payees, checks to the order of employees, irregular endorsements, forged endorsements, discrepancies as to payee and amount between checks and cash book, it is inconceivable that any accountant with experience could have

failed to establish the shortage in cash, even though the shortage occurred subsequent to the balance sheet date. This is a case where the accountant had every indication of a shortage before him but failed to recognize the indications, or else permitted himself to be influenced by the very implausible explanation of the bookeeper. Here, obviously, is a striking illustration of gross negligence. This plainly was an omission to do something which a reasonable man would have done, or the doing of something which a reasonable and prudent man would not have done.

The second incident relates to a case where the accountants were engaged to make an examination of financial condition as of December 31, 1928. Before entering upon the duties incident to this engagement, the accountants pointed out to the investment bankers, who were authorized to give the accountants their instructions, the fact that the purpose of the examination was to verify the financial condition as of a given date, and that the accountants would assume no responsibility for irregularities concealed in the operating accounts or transactions prior to the balance sheet date, or by manipulation of the records. This understanding was definite, positive, and of record.

The examination was completed, the report was rendered, qualifications necessary to protect the accountants because of difficulties encountered in verifying certain assets were incorporated in the comments preceding the certificate, and the report with certificate was addressed to the client.

About a year subsequent to the date of the balance sheet it was discovered that a dealer who discounted automobile paper with the client had perpetrated a fraud by obtaining funds through the use of irregular paper and multiple use of the same cars securing the paper. As a result of this fraud, the client suffered a large loss, and claiming that the shortage was in existence and represented by bogus paper at the time of the examination, threatened to bring an action against the accountants on the grounds of negligence.

An investigation of this claim proved conclusively that the accountants, during the course of their examination, had used due care and diligence in their work. The notes in question were in existence as of the balance sheet date and among those examined, the accompanying papers, including the chattel mortgage, appeared to be regular and had been passed by the credit manager, the disbursements constituting the ad-

vances to the dealer were verified, reasonable tests by inspection and verification of engine numbers had been made of cars securing the loans, and, further, all the notes in question subsequently had been collected by the company, the funds corresponding thereto having been deposited in the banks with which the client had accounts. Consequently, under the circumstances there could have been no question as to the integrity of these notes as representing part of the assets certified to as of the balance sheet date, and there could have been no negligence on the part of the accountants.

Confronted, as accountants are, with some uncertainty concerning their duty to third persons and, under certain circumstances, the possibility of unlimited liability, the matter of paramount importance seems to be one of avoiding negligence by adopting such procedure in every engagement that no one may charge them with lack of reasonable care and skill in their work. While there is the possibility always that they may be able to plead contributory negligence or intervening fraud, in one of the cases mentioned, intervening fraud by the client was stipulated but seems not to have relieved the accountants of their responsibility. The situation, therefore, crystallizes down to the point where if there has been no negligence on the part of the accountant, no duty to any one, whether under the theory of contract or of tort, will have been breached. It may be added, however, that the standards of judgment will be those prevailing in the particular locality where the service was performed.

There remains, however, the question of having a definite understanding with clients in each undertaking as to the character and scope of the work to be performed by the accountant. As a guide in this direction perhaps nothing has more value than the classification of accountancy services, which classifies, defines, and differentiates the various types of services performed. The accountant who undertakes to make an examination of financial condition as of a balance sheet date, knowing full well that such work does not call for a verification of transactions prior to the balance sheet date, will have no one but himself to blame, if he has failed to stipulate accordingly, and later some irregularity develops which obviously could have been detected only by a review of operating or of cash transactions.

In like manner, it is well known that a general examination in connection with proposed financing is for the purpose of determining that the financial condition as of a given date,

and the net profits for some period ended on that date, are as good, at least, as represented, and is not for the purpose of detecting shortages or irregularities by means of which the net assets and net profits are understated.

Accountants who fail to grasp these facts and to have an understanding with their clients, and with others involved, accordingly are likely to have law suits on their hands when some irregularity subsequently is discovered. By the same token, it is incumbent upon accountants, if they desire to protect themselves against the charge of negligence, to have an understanding in the case of a general audit that such engagement contemplates verification of all assets, liabilities, actual and contingent, reserves, capital, and surplus at a balance sheet date, together with the verification by means of tests (the character and extent of which are governed by the effectiveness of the system of internal control as determined by the accountant) of the transactions for a period ended on the balance sheet date.

No representations made in this paper properly may be taken to indicate a desire on the part of accountants to avoid their responsibilities as servants of the public. Rather, it is a brief for the exercise of intelligent consideration of their undertakings and duties, skill and care in their work, with a view to service which is honorable, professional, and dependable, while avoiding an onslaught of attack from irresponsible "racketeers" and unlicensed persons who seek to prey upon a young profession in the making.

STATE TAX LEGISLATION

Society's Committee Summarizes State Tax Situation, Invites Suggestions for Revision in Tax Laws

IN JANUARY of this year the Committee on State Taxation filed its report with the State Tax Commission and with the Legislature, and at the same time secured the introduction of a series of bills having for their purpose the amendment of the tax law in accordance with the recommendations contained in the report. Immediately after the introduction of the Committee bills a bill was introduced to create a Commission to study all the tax laws with a view to general amendment thereof. The State Tax Commission supported the latter bill and opposed the Committee bills. When we found it impossible to pass our bills, we supported the bill for a Commission to review all the tax laws, and that bill passed. (Chapter 726 of the Laws of 1930). The Commission has been appointed, will probably hold public hearings and presumably will recommend a more thorough revision of the tax laws than was contemplated by the Committee's report.

In addition to passing a bill creating a Commission for a general survey of the tax law, the Legislature adopted several important amendments to Article 9 and Article 9a on bills believed to be introduced at the instance of the State Tax Commission.

Section 182 of Article 9, affecting the franchise tax on real estate corporations, makes a radical change in the basis of tax on such corporations. The tax is now based not upon the value of the capital stock as heretofore, but upon the value of the gross assets employed within the State, and at the rate of ¼ of a mill on such assets. An additional tax has been imposed at the rate of 2% on all dividends paid during the year by real estate corporations, and dividends are defined as including interest paid on bonds, certificates of indebtedness, promissory notes or other indebtedness to stockholders, the proceeds of which are used to acquire assets. (Chapter 663 of the Laws of 1930 effective July 1, 1930).

Another radical change is the provision contained in Subdivision 2 of Section 182 as amended providing that any corporation taxable under this section shall at the time of its liquidation or prior to dissolution be subject to pay an additional tax at the rate of 2% based on any distribution of dividends from surplus since the close of the preceding tax year including any surplus which is then available, or to become available for distribution.

Section 211 of the tax law, Subdivision 12, has been amended to provide that if property of a real estate corporation is occupied wholly, or in part, by any corporation taxable under Article 9a (a business corporation) and such real estate corporation is owned or controlled by the corporation taxable under Article 9a, then the real estate corporation becomes taxable under Article 9a and the Commission may require the filing of a consolidated report. It is to be noted that the provision as to consolidated report is optional with the Tax Commission, but in any event the so-called real estate corporation becomes taxable under Article 9a.

Chapter 684 of the Laws of 1930, effective April 22, 1930, provides a new formula for computing the so-called "third minimum" tax on business corporations taxable under Article 9a. The minimum tax was raised from $10 to $25, and the third minimum is "not less than would be produced by applying a rate of 4½ per centum to a base found by using the following formula: From the sum of the entire net income and salaries and other compensation paid to all elected or appointed officers, and/or paid to any stockholder owning in excess of five per centum of the issued capital stock of the corporation, deduct as a specific exemption the sum of five thousand dollars and any net loss for the reported year. From the sum so found an exemption of seventy per centum thereof shall be granted and the remainder shall be used as the base of the tax; whichever of the three methods will result in the largest amount of tax."

The chairman of the temporary Commission for the revision of the tax laws has announced that public hearings will be held, and opportunity given to organizations to express opinions concerning the revision of the tax law. The Committee wishes to prepare a memorandum for submission to this Commission, and in order that the memorandum shall be as comprehensive as possible and embrace a view from as large a proportion of the membership of the Society as wishes to express its view, the Committee invites suggestions from all members concerning any revisions of the tax law, and particularly concerning changes in the tax on corporations subject to tax under Articles 9 and 9a. The co-operation from the members of the Society is cordially solicited.

All suggestions should be addressed to the Committee on State Taxation in care of the office of the Society, and should be submitted by November 30th, in order to enable the Committee to use them before the expected date of the public hearings.

ISIDOR SACK, *Chairman,*
Committee on State Taxation.

A SERVICE TO MEMBERS THROUGH TECHNICAL COMMITTEES

A CHANGE has been made in the plan for the work of the technical committees of the Society to enable them to function more effectively in rendering service to the members. This change has been brought about after study and conference with respect to the work of these committees.

The ambitious program, which was undertaken by the technical committees to produce, through research and study, reports dealing with special phases of accounting and accountancy practice, has proved a very difficult one for committees made up of busy members of the profession. For some committees it is an impossible task. Although one technical monograph has been issued and considerable work has been done by a number of committees, it was decided that there should be a modification in the plan for the work of these committees which would permit them to render immediate service with a reasonable expenditure of time and energy in their work.

Unless the committees themselves wish to undertake extended research work to the end of presenting reports which would be suitable for publication as technical monographs, they will not be expected to render such reports. They will, in the future, serve as reference committees and their research efforts will consist primarily of making readily available the existing technical literature applying to the field of each committee.

Inquiries coming to the Society for information in the field of any technical committee will be referred to it for consideration and report. It is not expected that a committee shall work out systems or forms for inquirers; the committees will be expected to deal with principles rather than their detailed application.

While the names of several committees correspond to titles of types of accountancy services and of special industry accounting, such designations are used merely for convenience. Members of such committees are not to be represented to the public as the specialists of the Society in special phases of accountancy practice.

The committees are being organized to handle their work in accordance with the revised plan which is outlined above and they will be glad to respond to reasonable requests from

the members. Members are invited to take advantage of the service thus provided and to submit to the Society any information, data, or suggestions which will be helpful to any of the committees or any recommendations for making the work of these committees of greater usefulness. This plan for service is based on co-operation and the co-operation of the members will help to make it successful.

WALTER A. STAUB,
Vice-President in Charge of Technical Committees.

TECHNICAL COMMITTEE SUBJECTS

The subjects covered by the fields assigned to the existing technical committees of the Society are as follows:

- Accountants' Office and Staff Management
- Accountants' Reports
- Accounting Machinery
- Auditors' Liability
- Automobile Dealers' Accounting
- Bank and Trust Company Accounting
- Budgets and Budgetary Control
- Building and Loan Association Accounting
- Business Laws
- Classification of Accountancy Services
- Clothing Manufacturing Accounting
- Consolidations and Reorganizations
- Contractors' Accounting
- Costs, Standard
- Court Testimony
- Fiduciary Accounting
- Foreign Trade Accounting
- Graphic Control and Ratios in Business
- Hotel Accounting
- Insurance Accounting
- Intangible Assets
- Inventory Methods
- Investment Trusts
- Liability for Material Commitments
- Management Problems
- Mining and Smelting Accounting
- Monthly Audits
- Municipal Accounting
- Non-Profit Institutions Accounting
- No Par Value Stocks
- Public Utilities Accounting
- Publishers' and Advertisers' Accounting
- Real Estate Accounting
- Retail Accounting
- Shipping Accounts
- Stock Brokerage Accounting
- Taxation, Federal
- Taxation, State
- Terminology
- Textile Accounting
- Training of Juniors
- Wholesale Accounting
- Working Papers, Preparation of